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Guest commentary -- Old tax laws don't work

Michelle Steel guest commentary
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During the infancy stages of digital entertainment, the music industry made a fundamental strategic mistake. Instead of finding a way to profit from and work with new music providers like Napster, the industry applied its old, failing business model to a new, revolutionary technology.

This one strategic mistake cost the industry billions of dollars a year to illegal piracy and is the primary reason why even today illegal song downloads outnumber legal downloads by a 20-1 margin.

Sadly, state lawmakers are about to repeat the same strategic mistake with digital entertainment by expanding ineffective tax laws to California's thriving tech sector.

Under a plan by Assemblyman Charles Carlderon, D-Montebello, California would begin imposing a new iTax on all digital products.

Just like the music industry's failure to work with a new medium, this new iTax could jeopardize California's multibillion dollar high-tech sector and permanently undermine California's overall tax base.

If you download a song on iTunes, you know the purchase is exempt from sales taxes. That's because California's sales and use tax law is strictly limited to tangible personal property. Digital products, which cannot be seen, felt or touched, are considered intangible and not subject to tax.

Assembly Bill 1956 would require the state Board of Equalization to apply California's 7.25 percent sales and use tax to all digital products like music, movie, ring tone and software downloads.

Recognizing the consumer shift toward digital commerce and a multibillion dollar budget deficit, Democrats want to impose a new sales tax on these digital downloads.

On the surface, the argument makes sense. Why should it matter whether a song is purchased online or from a physical store, especially if this new tax could generate up to $500 million per year in revenue? However, an old style tax code won't work with new technology.

When it comes to generating revenue, an iTax would be as effective as your e-mail program's spam filter. It's no coincidence that the Internet is referred to as the World

Wide Web. This universal access allows everyone to provide digital products to anyone from anywhere, worldwide.

Online media stores could easily create a separate entity out-of-state (or even out of the country); thereby, avoiding sales taxes altogether. Under such a situation, California taxpayers would be obligated to report those purchases individually and pay the "honor system enforced" use tax, which has a 99.8 percent noncompliance rate.

In the process, California would not only fail to capture the sales tax revenue, but lose the overall economic benefits of e-commerce. More so than any other state, California has scored big from e-commerce. Online commerce brings high-paying jobs, major economic benefits and significant tax revenue to the Golden State.

State government has received increased capital gains, property, income and business taxes from e-businesses.

In 2006, capital gains from the stock sales of just 16 Google employees generated $380 million in tax revenue for California. Compare that to less than $1.1 billion in lost California tax revenue from all of e-commerce and mail-order businesses.

Just 16 Google employees' capital-gains taxes offset close to 40 percent of the tax agency's estimated lost use-tax revenue from all of e-commerce.

Analysts predict that digital music sales will overtake conventional music sales by 2010, if not sooner. Last month, i-Tunes surpassed Target and Best Buy to become the number two music retailer in the country. Then, just this week i-Tunes will surpass Wal-Mart as the largest music retailer. California cannot afford to send this growing industry out of state.

Digital downloads have revolutionized the way we access entertainment. Old tax laws, like old business models, will fail to effectively harness this new technology. The music industry lost a fight with digital downloads once; state lawmakers shouldn't make the same mistake.

Steel represents California's Third District on the Board of Equalization, the state's elected sales tax board.